United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

ORIGINAL

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75-7503

P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

SUSAN TANNENBAUM,

Plaintiff-Appellant,

against

ROBERT G. ZELLER, *et al.*,

Defendants-Appellees.

REPLY BRIEF FOR PLAINTIFF-APPELLANT

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Docket No. 75-7503

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-against-

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Plaintiff-appellant submits this reply brief in response to the briefs filed by defendants-appellees F. Eberstadt & Co., Inc. ("Eberstadt"), F. Eberstadt & Co. Managers and Distributors, Inc. ("M&D") and Robert G. Zeller (hereinafter collectively referred to as "defendants") and by defendant-appellee Chemical Fund, Inc. ("Fund").

Argument

A. This is a Self-Dealing Case.

In their answering brief, defendants have skillfully and persistently obscured the fact that this case involves flagrant self-dealing by Eberstadt and M&D at the expense of the Fund. Under its management and distribution agreements with the Fund (Exh. 79), M&D, as manager of the Fund and principal underwriter, expressly agreed to pay all costs and expenses of the Fund in connection with (a) the furnishing of research and statistical services to the Fund and (b) the sale of the Fund's shares to the investing public. The relevant contract provisions are found in paragraphs 2, 3 and 5 of the Management Agreement and paragraph 6 of the Distribution Agreement.*

The Fund's Management Agreement provided on January 1, 1965, and with minor changes not pertinent here continues to provide, as follows:

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*At page 45 of their brief defendants assert:

> "It is significant that plaintiff can point to no specific provision of either contract which she claims was violated."

In light of the repeated references in our earlier brief to the precise paragraphs which were violated (pp. 13, 14, 26, 44-45), we think that defendants' assertion is somewhat extravagant, if not misleading.

"2. The manager shall furnish to the Board of Directors and officers of the Investment Corporation advice and recommendations with respect to the acquisition, by purchase, exchange, subscription or otherwise, the holding and the disposal, through sale, exchange or otherwise, of securities, and advice and recommendations with respect to other aspects of the business and affairs of the Investment Corporation; and shall, subject to the Board of Directors of the Investment Corporation, manage and supervise the business and affairs of the Investment Corporation.

"3. The Manager shall supply the Board of Directors and officers of the Investment Corporation with all statistical information reasonably required by them and reasonably available to the Manager; shall furnish the Investment Corporation with an office, and with ordinary clerical and bookkeeping services at such office; and shall authorize and permit any of its directors, officers and employees, who may be elected as directors or officers of the Investment Corporation, to serve in the capacities in which they are elected. All services to be furnished by the Manager under this Agreement may be furnished through the medium of any such directors, officers or employees of the Manager.

* * * * *

"5. As compensation for the services performed and the facilities furnished by the Manger, including the services of any consultants retained by the Manager, effective January 1, 1965, the Investment Corporation shall pay the Manager . . . a quarterly fee, as per the following rates, of the average daily net assets of the Investment Corporation. . . ." (Emphasis added.)

The Fund's Distribution Agreement provided on January 1, 1965, and with minor changes not pertinent here continues to provide, as follows:

"6. The Distributor shall assume and pay, or reimburse the Investment Corporation for, the following expenses of the Investment Corporation:

"A. Costs of qualifying the shares of the Investment Corporation for sale and, if necessary or advisable in connection therewith, of qualifying the Investment Corporation as a dealer or broker, in such states as shall be selected by the Distributor and fees payable to each state for continuing the qualification therein until the Distributor notifies the Investment Corporation that it does not wish such qualification continued.

"B. Costs of printing all copies of the Prospectus and of preparing and printing all other sales literature, if any, printed at the instruction of the Distributor.

"C. Counsel fees and expenses in connection with the foregoing.

"The Distributor shall also pay all its own costs and expenses and, generally, all costs and expenses connected with the sale of shares of the Investment Corporation, excluding issuance, transfer and registry charges and taxes, delivery and remittance expenses, and the costs of stock certificates, except that, the Distributor will pay all expenses incurred in connection with splitting the shares of the Investment Corporation." (Emphasis added.)

Notwithstanding the express language of these agreements, defendants urge that the allocation of brokerage to obtain research and statistical services "was always an implicit term of the Fund's management agreement" (p. 44) and that the allocation of brokerage to brokers who sell Fund shares "has always been implicit in the distribution agreement" (p. 45). Each of the agreements, however, spells out clearly and succinctly the nature and extent of M&D's obligation. Each contains explicit provisions setting forth M&D's compensation, and each contemplates that in performing the required

services, M&D may, at its own expense, employ the services of third parties. Not unexpectedly, neither agreement makes any mention of the use of Fund portfolio brokerage by M&D to satisfy its contractual obligation. Furthermore, the Fund's prospectuses, proxy statements and annual reports filed with the SEC make no mention of the use of brokerage for that purpose. In short, prior to the trial of this action the claimed "implicit " term of each agreement authorizing the use of portfolio brokerage to discharge M&D's obligations had never previously been disclosed to anyone.

In January 1972, shortly after the Supreme Court's denial of a petition for writ of certiorari in Moses v. Burgin (404 U.S. 944), the management of the Fund caused a proxy statement (Exh. 35) to be sent to the Fund's shareholders recommending their approval of an amendment, which was approved on March 14, 1972, authorized the Fund's directors to "determine in their discretion the manner and purposes of the allocation of brokerage commissions to be paid by the Fund. . . ." (A-31). The proxy statement, quoted at length at pages 13-14 of defendants' brief, contained the following statement:

> "The purpose of the above amendment is to make explicit that which has always been implicit, namely, that the Board of Directors of the Fund

(more than 50% of whom are otherwise unaffiliated with the Fund or its Manager) has the power to determine how the portfolio brokerage of the Fund shall be used. In the opinion of the Board of Directors of the Fund, it is in the best interest of the Fund to continue the brokerage practices which it has followed since inception under which all portfolio transactions have been carried out by brokers who are not affiliated with the Manager and Distributor of the Fund and not to make any provision for recapture through an affiliated broker of any part of the brokerage commissions paid by the Fund." (Emphasis added.)

The 1972 proxy statement artfully concealed more than it revealed. Although the Fund's management sought to obtain a free hand in the allocation of portfolio brokerage on the representation to the shareholders that that had always been "implicit", no mention is made anywhere in that document of the fact that M&D was obtaining direct, substantial benefits from the allocation of portfolio brokerage. Indeed, by emphasizing that the brokers who received the allocation were not affiliated with M&D, defendants led the shareholders to believe that M&D had no pecuniary interest in the allocation of portfolio brokerage. The 1972 amendment and the proxy statement by which defendants obtained shareholder assent are symptomatic of the continued concealment by defendants of the fact that the use of recapturable commissions to compensate independent brokers for research and statistical services and sales of Fund shares enriched M&D at the expense of the Fund.

As we pointed out in our earlier brief (p. 45), the direct cost to M&D of performing the investment advisory and distribution functions was high, its net operating expenses having risen from over $1 million dollars in 1966 to over $2.1 million in 1972 (Exhs. 93-97; Exh. A). The expenses reflected in M&D's financial statements, however, do not include the additional amounts paid by the Fund as "give-ups" and reciprocals" to independent brokers for assisting M&D in performing those functions. If these costs and expenses had been paid by M&D itself as required under the express terms of the management and distribution agreements, the substantial profits earned by M&D each year from operating the Fund would have been reduced. By failing to recapture excess commissions for the benefit of the Fund, defendants permitted M&D, which received total direct compensation from the Fund ranging from $2.8 million in 1965 to $14.3 million in 1973 (A-30 and A-33), to maintain a high level of profitability at the expense of the Fund.

In their brief defendants offer a plethora of arguments in support of their contention that M&D did not profit from the Fund's failure to recapture. None of these arguments, however, passes the test of common sense. If, as plaintiff contends, M&D had a contractual obligation to pay certain costs and expenses of the

Fund out of its own assets but instead used assets of the Fund to satisfy that obligation, it necessarily follows that M&D profited at the expense of the Fund. The fact that the costs incurred may have benefited the Fund or led to superior sales or investment performance is totally irrelevant so long as the contractual obligation to pay those costs rested with M&D, As we noted above (p. 8, <u>supra</u>), M&D was amply compensated under the formulas contained in the management and distribution agreements both for its services and for the expenses it paid on behalf of the Fund. It had no reason to expect, and no right to receive, additional compensation.*

Defendants vigorously urged at numerous points in their brief (pp. 15, 26, 27, 28, 45) that the

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*Equally irrelevant are defendants' contentions that (a) the research provided by independent brokers did not reduce M&D's operating costs (p. 27) and (b) in some of the years M&D sustained losses in the performance of the distribution function (p. 45). As to the first point, it is sufficient to observe that under the Management Agreement, M&D, in return for the multi-million dollar fee it received annually from the Fund, was obligated to provide research at its own expense. If it decided to augment its own research through outside sources, it was contractually committed to bear the cost itself. Defendants' second point is equally unpersuasive. By promoting sales, M&D was able to increase substantially the asset base on which its management fee was computed. Even though it lost money on the distribution function in certain years, its combined income from the Fund under the management and distribution agreements resulted in substantial profits each year (Exhs. 93-97; Exh. A).

use of portfolio commissions to compensate independent brokers for sales and for research and statistical services was "an industry-wide practice" (p. 45).* It seems self-evident, however, that the mere fact that the practice was widespread would not justify an otherwise unlawful act. The law has never sanctioned illegal conduct on the ground that other persons have engaged, or are engaging, in the same conduct. Moreover, defendants have not cited a single authority that holds that the use of portfolio brokerage for the fund manager's own benefit is lawful. Indeed, every authority both judicial and administrative of which we are aware (other than the decision in the court below) holds directly to the contrary.** See, e.g., Moses v.

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*Defendants also contend that the allocation of commissions to such brokers was a "competitive necessity" (p. 26); and that there was no other way to compensate these brokers for these services (p. 28). This, of course, is sheer hyperbole, since fund managers always could have, and presently do, purchase these services for cash. Prior to the spate of lawsuits spawned by Moses v. Burgin, however, fund managers routinely used fund portfolio brokerage to pay for these services.

**The sole possible exception is Fogel v. Chestnutt, 383 F. Supp. 914 (S.D.N.Y. 1974), which is presently on appeal to this Court (Calendar No. 74-2582). In that case, however, the District Court held that recapture for the benefit of the fund was impossible, since neither the adviser nor any affiliate of the adviser was a member of the NASD or of any exchange:

> "The use of reciprocals and give-ups did not cause any damage to Fund unless plaintiffs can establish that they, or a part of them, could have been recovered for the benefit of Fund" 383 F. Supp. at 919.

Burgin, 445 F.2d 369 (1st Cir.), cert. den. sub. nom. Johnson v. Moses, 404 U.S. 994 (1971); Matter of Cornfeld, CCH Fed. Sec. L. Rep. (1970-1971 Transfer Binder) ¶77,963 (S.E.C. 1971); Matter of Provident Management Corp., CCH Fed. Sec. L. Rep. (1970-1971 Transfer Binder) ¶77,937 (S.E.C. 1970).

Furthermore, although the practice was widespread, members of the industry, when challenged with litigation, have generally not sought to defend it. As defendants' counsel are aware, virtually all the more than 50 cases filed by shareholders attacking the legality of the practice have been settled for sums conservatively estimated to total more than $20 million. These cases involved many of the largest and most prominent funds and fund groups, including Anchor, Axe-Houghton, Colonial, Dreyfus, Fidelity, Fundamental, Guardian Mutual, Keystone, Manhattan, M.I.G., M.I.T., Oppenheimer, Putnam, Scudder, United, Value Line and Wellington. Accordingly, defendants' assertion (p. 7) that the larger funds in the industry have not sought to reduce their management fees by recapture devices ". . . except to the extent that some funds have entered into such arrangements in order to settle stockholder litigation. . . ." should not be construed as implying that the larger funds have defended the practice or resisted the change.

In Matter of Arthur Lipper Corporation, (S.E.C. Release No. 34-11773), an as yet unreported decision of the SEC handed down on October 24, 1975, the Commission reiterated once more the unyielding principle that the investment adviser and distributor of a fund may not appropriate for themselves benefits derived from the execution of fund portfolio transactions (p. 21). In Lipper, the fund's investment adviser (IOS) and its distributor (IPC, a subsidiary of IOS) entered into various arrangements with executing brokers under which substantial portions of the commissions generated both in the over-the-counter market and on the New York Stock Exchange were channeled back to IPC and IOS. In an extensive opinion ranging widely over the rules and practices of the securities markets and portfolio practices in the mutual fund industry the Commission held that the diversion by respondents for their own benefit of "excess brokerage" (the Commission's term -- see Release, p. 3) arising from transactions in both markets constituted a fraud in violation of Rule 10b-5 (Release, pp. 10-11 and p. 21).

The Commission's discussion of rebates obtained in New York Stock Exchange transactions is of particular relevance here (Release, pp. 19-28). First, it should be noted that, in contrast to the facts presented in this case, since neither IOS nor IPC was a Stock Exchange member, neither was in a position to obtain rebates for the fund of excess commissions generated in Exchange transactions (Release, p. 19). Respondents claimed, therefore, that under the Exchange's anti-rebate rules, it was impossible for the fund to benefit from excess brokerage and accordingly, that the use of such commissions for their own benefit was unassailable. (Release, pp. 21-22). The Commission accepted, arguendo, respondents' contention that no direct pecuniary benefits could lawfully be channeled back to the fund (FOA) from Exchange transactions (Release, p. 22). The Commission went on to hold, however, that even though respondents were under no duty to exercise their power to allocate the fund's portfolio brokerage for reciprocal purposes, if in fact they chose to do so, they were obligated as a matter of law to use that power for the fund's benefit and not for their own.

> "In the circumstances of this case, the IOS respondents were under a duty to deploy excess brokerage or 'brokerage power' for the fund's benefit, not theirs. It follows that, if they had the capacity to cause any part of the commissions to leave the hands of the executing broker,

> they were bound to use that part to buy research and related services of value to FOA's shareholders . . . To the extent respondents chose to induce the executing broker to give up a portion of the commissions, they could not cause it to benefit themselves in preference to FOA." Opinion, pp. 22-23.

The facts in this case are even stronger and more compelling than those in Lipper. It has been stipulated in this action that Eberstadt has at all times since January 1, 1965, been a bona fide member of the New York Stock Exchange and, since 1968, of the American Stock Exchange (A-29). By reason of those exchange memberships, the Fund, at all relevant times, could have recaptured a portion of the commissions generated in portfolio transactions on those exchanges without violating the anti-rebate rules of those exchanges (A-36). Furthermore, unlike the respondents in Lipper, M&D had an express contractual obligation to pay all costs and expenses of the Fund in connection with sales of Fund shares and the acquisition of research and statistical information. Thus, use of the Fund's recapturable commissions to pay those costs and expenses was tantamount to putting them into defendants' own pockets, even though the services purchased had value to the Fund. In this case, as in Lipper, defendants chose to exercise their power to allocate

portfolio brokerage for reciprocal purposes rather than let that power lie dormant.* Having used that power for their own benefit rather than for the benefit of the Fund (and, in this case, to the detriment of the Fund), they breached their fiduciary obligation to the Fund and violated Rule 10b-5 as well as other provisions of the federal securities laws.

B. Defendants are liable to the Fund whether or not the Fund's directors exercised a good faith business judgment in determining not to recapture.

The briefs submitted both by defendants and by the Fund proceed generally on the theory that, if the Fund's directors determined in the exercise of their business judgment not to require recapture for the Fund's benefit, defendants Eberstadt, M&D and Zeller are thereby insulated from all liability. In our initial brief (pp. 60-61), we pointed out that, even if the Fund's directors had properly exercised a "business judgment" in failing to recapture, that

*Since it has been stipulated in this action that virtually all of the Fund's portfolio brokerage was allocated for give-up and reciprocal purposes (See A-38, xxxv and xxxvi; compare A-35, xxvii, and A-37, xxxii and xxxiv, with A-34, xxi), we need not concern ourselves with the nature of M&D's fiduciary obligation if it had determined not to exercise its power to allocate brokerage for those purposes.

would not excuse defendants' failure to make disclosures required by the federal securities laws to be made in the Fund's prospectuses, proxy statements and reports filed with the SEC, and we will not repeat those points here. The impact of the "business judgment rule" so far as plaintiff's breach of fiduciary duty claim is concerned, however, merits further comment.

Nothwithstanding defendants' repeated invocation of the "business judgment rule" as a complete defense, plaintiff respectfully submits that that defense has no application so far as these defendants are concerned. In their brief (p. 43) defendants cite the traditional authorities in support of the proposition that, where corporate directors have acted in good faith, the court will not substitute its judgment for that of the directors. The thrust of the doctrine, however, is to protect the directors against liability in those cases where their judgment as directors is called into question. It is not available as a defense to fiduciaries (whether or not they are directors) who have obtained illicit profits at the expense of the corporation, and the cases cited by defendants do not hold to the contrary.

In seeking to establish an immunity for themselves under the "business judgment rule", defendants claim too much. None of them is sued here in the

capacity of a director,* nor is the claimed liability of any of these defendants predicated on any error in judgment. As pointed out earlier (pp. 2-15, supra), this is a self-dealing case involving the wrongful diversion of Fund assets for defendants' own benefit, and no citation of authority is required to show that under those circumstances defendants are liable to the Fund.

Moreover, under familiar trust principles, defendants, as fiduciaries, could not lawfully keep profits obtained by them at the expense of their cestue que trust even assuming, arguendo, that they were themselves innocent of any wrongdoing.

> "The trustee is accountable for any profit made by him through or arising out of the administration of the trust, although the profit does not result from a breach of trust." Restatement, Trusts 2d § 203 (1959).

And it is familiar law that a fiduciary may be held liable for his profits even if he acted in good faith

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*Eberstadt and M&D are clearly not directors of the Fund, though they are fiduciaries. Matter of Arthur Lipper Corporation, supra, p. 10, fn. 25; Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), petition for cert. dismissed 409 U.S. 802 (1972); Brown v. Bullock, 194 F. Supp. 207, 229 (S.D.N.Y. 1961), aff'd 294 F.2d 415 (2d Cir. 1961). Defendant Zeller is sued herein not in his capacity as a director of the Fund but, among other things, as a controlling person of Eberstadt and M&D under Section 48 of the Investment Company Act and Section 20 of the Securities Exchange Act.

in the belief that his actions were proper. See, e.g., Wilshire Oil Co. v. Riffe, 381 F.2d 646, 651-52 (10th Cir.), cert. denied 389 U.S. 822 (1967); Fleishhacker v. Blum, 109 F.2d 543, 545-46 (9th Cir.), cert. denied 311 U.S. 665 (1940); Winkelman v. General Motors Corp., 44 F. Supp. 960 (S.D.N.Y. 1942); Epstein v. Schenck, 35 N.Y.S.2d 969 (Sup. Ct. N.Y. Co. 1939).

In its decision in Matter of Arthur Lipper Corporation, supra, the Commission applied the related principle that, even when a fiduciary is under no duty to act in relation to the trust, if he does act, he may not profit at the expense of the trust. In that proceeding the Commission accepted, for purposes of argument, respondents' contentions that (a) under the anti-rebate rules of the New York Stock Exchange they were not permitted to channel recapturable commissions to the fund and (b) they were therefore under no obligation to exercise their control over the allocation of the fund's portfolio brokerage to recapture excess commissions for the fund (Opinion, p. 22). Nonetheless, once respondents determined to utilize that power, they were under a fiduciary obligation to allocate portfolio brokerage for the fund's benefit, not their own.

> ". . . . To the extent respondents chose to induce the executing broker to give up a portion of the commissions, they could not cause it to benefit themselves in preference to FOA." Opinion, pp. 22-23.

Under the circumstances of the present case, even apart from M&D's express contractual obligation to pay out of its own funds all costs and expenses of the Fund in connection with sales of Fund shares and the acquisition of research and statistical data, it was a clear breach of its duty of undivided loyalty to the Fund to profit by allocating Fund portfolio brokerage to pay those costs and expenses.

C. Reliance by the Fund's directors on "advice of counsel" is no defense to plaintiff's claim.

The thrust of the defense of this action has from the outset been that the Fund's board of directors exercised an independent business judgment not to recapture after consulting and relying upon the advice of counsel.* For reasons which we stated earlier

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*Defendants' brief (p. 1) erroneously states that it has been stipulated by plaintiff that at all relevant times a majority of the directors were "independent". (A similar statement is made at page 2 of the Fund's brief.) While plaintiff has stipulated that at all times a majority of the directors were neither "affiliated persons" nor "interested persons" within the meaning of certain provisions of the Investment Company Act (A-29), defendants apparently wish to gild the lily. Although the "independence" of the unaffiliated directors -- if it exists -- is irrelevant to plaintiff's claims, it stretches credulity to believe that these outside directors, nominated to the board of a fund organized and operated by Eberstadt and all of whose officers were officers of M&D, Eberstadt's wholly-owned subsidiary, were inclined or able to take an independent stand on any matter of importance.

(pp. 15-19, supra), the "business judgment rule" does not afford any defense to these defendants, none of whom is sued in the capacity of a director. It follows for the same reasons that the advice which was rendered to the Fund's directors, even if relied on by them, does not insulate defendants from liability for profits which they obtained at the expense of the Fund.

Even if "advice of counsel" had some relevance in this action, defendants have not shown such circumstances as would warrant giving the advice rendered in this case any weight. First, the advice in question, viz., the written opinion rendered to the Fund's directors by Sullivan & Cromwell on February 20, 1968 (Exh. 75) and the oral advice given by that firm in 1971 following the Moses decision (Tr. 170-171), was not given by disinterested counsel. Defendants do not deny that Sullivan & Cromwell was counsel at all times for Eberstadt and M&D as well as the Fund, and there is no reason to suppose that it was not routinely consulted by these parties regarding the brokerage practices involved in this action and other matters relating to the operation of the Fund. Certainly there is nothing in the record to suggest that that firm was "disinterested" in the sense that it was retained by the Fund's unaffiliated directors to render an independent opinion on these

practices, uninfluenced by the firm's continuing relationship with Eberstadt and M&D. When Sullivan & Cromwell undertook to advise the Fund's directors regarding recapture, it placed itself in the position of advising parties with conflicting interests, and it is axiomatic that when a lawyer who represents one party to a transaction renders advice to another party, the former cannot vindicate his own misconduct on the ground that counsel, in giving advice to the other party, was "independent". Compare Zewadski, Trustee v. Johnston, Lemon & Co., CCH Fed. Sec. L. Rep. (Current Binder) ¶95,353. (D.D.C. 1975).

Second, there is nothing in the record to suggest that defendants relied on advice of counsel in deciding to use recapturable commissions to discharge M&D's obligations under the management and distribution agreements. In fact, defendants repeatedly stress in their brief that they allocated portfolio brokerage for reciprocal purposes, because it was the practice in the industry to do so (pp. 15, 27). Moreover, even if they had received the advice of their own counsel that, notwithstanding the fiduciary capcity in which they stood, they could use recapturable commissions for their own benefit rather than the benefit of the Fund, they can hardly claim reliance on that advice as a defense to an action by the cestui que trust to compel them to account for their profits. See Matter of Arthur Lipper

Corporation, supra, p. 16; Matter of Cornfeld, CCH Fed. Sec. L. Rep. (1970-1971 Transfer Binder) ¶77,963 at p. 80,137 (S.E.C. 1971) Bisno v. United States, 229 F.2d 711, 719 (9th Cir. 1961), cert. denied 370 U.S. 952 (1962).

Finally, we question whether Sullivan & Cromwell's two-page written opinion (Exh. 75) is entitled to any weight under any circumstances. As defendant Zeller testified (Tr. 56-57), that opinion was obtained in 1968 following the publication of the SEC's proposed Rule 10b-10, which would have required recapture for the benefit of the fund if the fund manager had the means to do so. The firm's opinion is a model of brevity. It states that counsel has reviewed the release containing the proposed rule, the Investment Company Act and, without specification, "such other matters of law as we have considered appropriate." It then concludes:

> "On the basis of the above and assuming that the Board of Directors has considered all the relevant facts concerning this matter, including the possibility of adopting alternate methods of handling the Fund's brokerage business whereby a portion of the commissions might be used to reduce the management fee, and assuming further that, as a result of such consideration, the Board of Directors has come to the conclusion as a matter of reasonable business judgment that it is in the best interest of the Fund and its shareholders that the continuation of the present method of placing brokerage orders and directing "give-ups" be approved, it is our opinion that such approval would be lawful."

The opinion, to the extent that it is relied on by defendants to insulate them from liability, is manifestly deficient. It does not contain any discussion of the principles of trust law that would preclude Eberstadt and M&D as fiduciaries from profiting at the expense of the trust, even though that subject was explored at length in the SEC release. Furthermore, nowhere does the opinion advert to the fact that by using recapturable commissions to discharge M&D's obligations under the management and distribution agreements, M&D was already engaged in a practice involving self-dealing at the expense of the Fund. It seems fair to conclude that that opinion was never intended to provide any meaningful evaluation of the facts and the law but was designed to afford the Fund's directors a defense, based on "advice of counsel", against possible liability arising from the Fund's failure to recapture.

D. <u>Defendants' contention that plaintiff cannot assert a claim under § 36(a) of the Investment Company Act as amended is without merit</u>.

Defendants contend in their answering brief (pp. 18-23) that, to the extent that plaintiff's claims arise under § 36(a) of the Investment Company Act of

1940, as amended in 1970, plaintiff (a) lacks standing to sue and (b) in any event, has failed to prove that defendants have engaged in an "act or practice constituting a breach of fiduciary duty involving personal conduct" as provided in that section.*

Defendants argue for a construction of § 36 as amended that would emasculate § 36(a) and diminish, rather than enhance, the protections afforded mutual fund investors under that section. They contend first that the 1970 amendments were designed to eliminate any private right of action for violations of the Act, other than an action of the kind permitted under new § 36(b). That construction of the 1970 amendments, however, lacks any support whatever in the legislative history. Indeed, the reports in both houses of Congress expressly state that "the fact that subsection (b)

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*Defendants imply, but do not state, that plaintiff would not be entitled to any relief in this action if she failed to establish a claim under § 36(a), as amended effective December 14, 1970. To reach that conclusion defendants ignore the fact that the complaint in this action (filed in May 1971) alleges violation of various provisions of federal and state law (including but not limited to violations of the Investment Company Act) commencing in 1965. Thus, even if there were merit to defendants' contentions regarding § 36(a) as amended, plaintiff's claims arising under old § 36 of the Act prior to its 1970 amendment and under other provisions of federal and state law would be unaffected.

specifically provides for a private right of action should not be read by implication to affect subsection (a)".* The meaning could not be clearer; yet defendants, without any supporting authority in the legislative history, ask this Court to construe §36(b) as wiping out by implication all private rights of action for violations of the Act.**

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*Report of the Committee on Banking and Currency, Senate Report No. 91-184 (1969), p. 16; Report of the Committee on Interstate and Foreign Commerce, House Report No. 91-1382 (1970) p. 38.

** In their citation of Monheit v. Carter, 376 F. Supp. 334, 342 (S.D.N.Y. 1974), defendants misstate the thrust of Judge Tyler's opinion. In that case defendants were alleged, among other things, to have caused an investment company, Fifth Avenue Coach Lines, Inc. ("Coach Lines"), to purchase as an investment 10 per cent of the common stock of Elgin National Industries, Inc. ("Elgin"), an unrelated third party. 376 F. Supp. at 339. Plaintiff claimed that the purchase was imprudent and not in the best interests of Coach Lines. The Court said:

> "Even if imprudent, the acquisition of Elgin stock may well not constitute a violation of the Investment Company Act . . . Section 36(a) of the Investment Company Act, 15 U.S.C. §80a-35(a), authorizes the SEC to bring actions against certain individuals or companies for breaches of fiduciary duty involving personal misconduct. Section 36(a), however, authorizes an action by the SEC, not by private individuals. Although this should not be read to prohibit suits by individuals when other sections of the Investment Company Act are violated, when only a general breach of fiduciary duty is alleged, a private suit should more properly be brought in state court. Even if this claim is a state claim, however, this court will take pendent jurisdiction over it in this case."

(Footnote cont'd on next page)

That Congress did not intend by enacting § 36(b) to eliminate private rights of action for other violations of the Act is manifest in the language of § 36(a) and § 36(b). The former applies to "any act or practice constituting a breach of fiduciary duty involving personal misconduct". The latter is limited in application to "receipt of compensation for services, or payments of a material nature" paid by an investment company to an investment adviser or an affiliated person of the adviser, both of whom, for purposes of subsection (b), are deemed to have a fiduciary duty with respect to such compensation or payments. It is plain that subsection (b) has a much narrower scope than subsection (a) and is designed to apply only to the question of allegedly excessive management fees. If defendants' construction of the 1970 amendments were correct,

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** (footnote continued from previous page)

It is plain that, contrary to defendants' assertions here, Judge Tyler did not read § 36(b) as precluding by implication a private right of action under § 36(a). Moreover, while he stated that "when only a general breach of fiduciary duty is alleged", a private suit should "more properly" be brought in state court, that dictum (without citation of any authority) does not apply here. First, plaintiff is not alleging a "general breach of fiduciary duty", but a deliberate misuse of Fund's assets for the benefit of defendants themselves in violation of federal law. Moses v. Burgin, 445 F.2d at 373 and 384; Matter of Arthur Lipper Corporation (S.E.C. Release No. 34-11773, October 24, 1975). Second, other substantial violations of the Investment Company Act are also involved.

Congress, instead of broadening the protections available to mutual fund investors, would have narrowed them to one small area of potential abuse and would have precluded private litigants from recovering damages even in cases where a "breach of fiduciary duty involving personal conduct" had been pleaded and proved. We have not found any authority whatsoever to support that construction. See, generally, Mutual Funds and Independent Directors: Can Moses Lead to Better Business Judgment? 1972 Duke L.J. 429 at 430-435.*

We next turn to defendants' contention (p. 21) that, even if a private right of action may be maintained under § 36(a), plaintiff has failed to prove "personal misconduct", which is "central to the statutory scheme". The gist of defendants' argument seems to be that "personal misconduct" means the conduct of a natural person, and, since all the "individuals" involved acted "honestly", the complaint must be dismissed.

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*Because § 36(a) became effective on December 14, 1970, but § 36(b) did not become effective until June 14, 1972, defendants' proffered construction of the 1970 amendments, if adopted, would lead to the absurd result that there would be an 18-month hiatus during which there would be no private right of action whatever under § 36, regardless of the character of the wrong. There is nothing in the legislative history to suggest that Congress intended any such result.

The vice of defendants' argument is that it (a) flies in the fact of the statute itself, (b) is contrary to the legislative history and (c) leads to absurd results. Section 36(a) applies by its terms to a "person" serving or acting in one or more of certain specified capacities. Section 2(a)(28) of the General Definitions under the Act states as follows: "'Person' means a natural person or a company". As that subsection indicates, when Congress wished to deal specifically with human beings, it used the term "natural person". See, e.g., § 2(a)(12) ("director") and § 2(a)(19) ("interested person"). It seems obvious that "personal conduct" refers to the conduct of a "person" acting in one of the capacities specified in § 36(a).* Moreover, the capacities described in § 36(a) are precisely the same capacities as those described in old § 36. Not only does defendants' construction do violence to the statutory language, but, so far as the legislative history is concerned, there is no basis whatever to support the conclusion that Congress decided in 1970 to limit the SEC's authority to restrain

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*While an officer, director or member of an advisory board would normally, but not necessarily, be a natural person (see, e.g., § 2(a)(12)), an investment adviser, depositor or principal underwriter would normally, but not necessarily, be a corporation.

breaches of fiduciary duty to natural persons only.*

Even the selective portion of the legislative history quoted by defendants at page 22 of their brief demonstrates just what it was that Congress had in mind in using the phrase "personal misconduct". The SEC was authorized to seek injunctive relief only in those cases where misconduct was chargeable to a specific "person" under the Act. The Commission was to be precluded, however, from using its injunctive powers under § 36(a), rather than its rule-making powers under § 38(a) of the Act, to restructure the industry or attack industry-wide practices. That construction comports squarely with the objective of Congress in adopting the 1970 amendments to strengthen, not diminish, the protections available to mutual fund investors.**

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*The construction urged by defendants would lead to the absurd result that natural persons could violate the Act with impunity merely by incorporating or acting through a trust or other entity.

**As we note above (p. 23, fn., <u>supra</u>), even were defendants correct in their construction of § 36(a), plaintiff would still be entitled to relief under § 36 to the extent that her claims arose on or before December 14, 1970, and under other provisions of federal and state law from January 1, 1965, to date.

E. Plaintiff is entitled to injunctive relief and damages arising from defendants' failure to make proper disclosures in the Fund's proxy statements, annual and quarterly reports and prospectuses.

Rather than deal with plaintiff's non-disclosure claims on the merits, defendants attempt to bury them under an avalanche of digression. Defendants assert that these claims are "mere after-thoughts" (p. 48). Although neither the complaint nor the pre-trial order specifically spells out plaintiff's non-disclosure claims, they are integrally related to plaintiff's other claims; the documents relied on were introduced in evidence at the trial without any objection by defendants' counsel (Tr. 10-11); defense witnesses were questioned about the disclosures in those documents (Tr. 135-138, 196-199); the issues were briefed before the District Court; and the District Court specifically dealt with those issues in its opinion. (A-72 ff.). Defendants' effort to sweep those claims aside can only be construed as a desperate gambit to avoid the unavoidable.

We see no need to repeat the arguments on non-disclosure presented in our earlier brief (pp. 50-58), since defendants do not even suggest in their abbreviated rejoinder that there was disclosure in the various documents issued to Fund investors or filed with the SEC

regarding M&D's use of portfolio brokerage to discharge its contractual obligations under the management and distribution agreements. Defendants do make two points, however, for which reply is appropriate.

First, defendants contend (pp. 46, 48) that, since the directors determined that there would be no recapture, that in itself excused any duty to disclose. That contention is preposterous. It is tantamount to asserting that the directors of a company need not make disclosure of self-dealing arrangements involving persons who stand in a fiduciary relation to the company if the directors believe that those arrangements should be permitted to continue. That would be novel doctrine indeed, inasmuch as the various provisions of the securities laws dealing with disclosure to investors and shareholders are replete with requirements that all material transactions with officers, directors and other affiliated persons be disclosed, and, as we noted in our earlier brief (p. [illegible], fn.), special disclosure requirements are mandated under the Investment Company Act where the investment adviser and distributor of a mutual fund are involved.

Second, defendants contend (p. 48) that even if the Fund's prospectuses and proxy statements were false and misleading, Fund shareholders have not been injured and therefore have no right to relief.

This too is manifestly untenable. At a mimimum, the shareholders of a company have standing to correct materially false and misleading proxy statements, Mills v. Electro Auto-Lite Co., 396 U.S. 375 (1970), and there is no reason to suppose that a shareholder cannot seek the same relief in the case of a false and misleading prospectus. Moreover, plaintiff has established that the Fund suffered real and substantial damage by reason of non-disclosure of material facts in the Fund's proxy statements. Assuming, arguendo, that the failure to recapture can be justified on the basis that the Fund's directors determined annually -- as a matter of policy -- not to require recapture, the shareholders were entitled to full disclosure of all material facts relating to the effect of that policy on the interests of the Fund. Moreover, to the extent that defendants rely on the 1972 amendment to the Fund's certificate of incorporation or on the election of the management slate of directors each year as an implicit sanction for modification of the terms of the management and distribution agreements, there is a direct causal connection between the Fund's proxy statements and the harm alleged by plaintiff. By concealing the fact that failure to recapture meant that M&D was able to use Fund portfolio brokerage to discharge its contractual obligation to pay certain costs and expenses of the Fund, the Fund's officers (all of whom

were officers of M&D) deprived the shareholder of any meaningful chance to express their approval or disapproval of that policy. Under the federal proxy rules nothing more need be shown to establish plaintiff's right to relief. Mills v. Electro Auto-Lite Co., supra.

Conclusion

For the reasons stated here and in plaintiff's earlier brief, the judgment of the District Court should be reversed.

Dated: New York, New York
December 31, 1975

Respectfully submitted,

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375—Affidavit of Service

The Reporter Co., Inc., 11 Park Place, New York, N. Y. 10007

UNITED STATES COURT OF APPEALS : for the Second Circuit

TANNENBAUM

VS

ZELLER

AFFIDAVIT OF SERVICE

STATE OF NEW YORK,
COUNTY OF NEW YORK, ss:

BERNARD S. GREENBERG being duly sworn, deposes and says that he is over the age of 21 years and resides at

That on the 31st day of december , 1975 , 1975 he served the annexed reply brief for plaintiff-appellant upon

Sullivan & Cromwell, Atty's for Eberstadt & Zeller, 48 Wall Street, N.Y, N.Y.

Walsh & Frisch, , Atty's for Chemical fund, 250 Park Avenue, N.Y. MNY

in this action, by delivering to and leaving with said attorneys

three true copies to each thereof.

Deponent Further Says, that he knew the persons so served as aforesaid to be the persons mentioned and described in the said action.

Deponent is not a party to the action.

Sworn to before me, this 21st

day of december 1975, 1975 } Bernard S Greenberg

Roland W. Johnson

ROLAND W. JOHNSON
Notary Public, State of New York
No. 4509705
Qualified in Delaware County
Commission Expires March 30, 19